# The tax rules that lie behind Pillar One and Pillar Two

International Tax

24 November 2022

We examine the tax rules that lie behind Pillar One and Pillar Two, and ask where we are now in the move towards a new global framework.

It has been just over a year since political agreement was reached by more than 135 of the/G20 Inclusive Framework on BEPS (‘the Inclusive Framework’) member countries on the ‘two-pillar’ approach:

- Pillar One: rules for reallocating profits to market countries; and
- Pillar Two: introducing global minimum tax rules.

Significant work has been undertaken by the OECD Inclusive Framework over the last 12 months and, as 2023 will see a move into the implementation phases of the work, it is important to take stock of the latest developments on the different workstreams.

# Pillar One

## Amount A: nexus and profit allocation rules

Progress has been made over the last 12 months on the development of draft model rules from a technical perspective, but political challenges remain – particularly in relation to US domestic approval of the changes, which will be essential for implementation.

Amount A is, at least for now, of relevance only to the very largest groups as it applies to multinational businesses with:

- global annual turnover above €20 billion; and
- profitability above a 10% margin.

Exclusions apply for businesses in the extractive and regulated financial services sectors. The rules are initially expected to apply to around 100 businesses globally, but the global annual turnover threshold may be reduced to €10 billion in the future, depending on a successful implementation of Amount A.

The 'Amount A' proposal reallocates taxing rights in favour of market countries through the creation of a new taxing right. In-scope businesses will reallocate 25% of their residual profit above a 10% profit level to market countries using a revenue-based allocation key. A progress report containing draft domestic model rules was released in July and followed seven earlier smaller consultations on the 'building blocks' of the rules. A second progress report, released in October, set out proposals for the tax administration and tax certainty aspects of Pillar One.

There remain a number of open issues and points of detail to be developed and agreed, including in relation to withholding taxes (in particular on royalties), which already give taxing rights to market countries. Further work is also being undertaken on the proposed marketing and distribution safe harbour to address 'double counting' issues where a market country already taxes the same item of residual profit. Elimination of double taxation swiftly and efficiently remains key to the 'reallocation' objective of Amount A and is a significant concern for businesses.

The intention is for the Amount A rules to be included in a multilateral convention, which will enter into force only after ratification by a 'critical mass' of countries. This includes countries of the parent entities of a substantial majority of in-scope groups (e.g. the US, Japan, Germany, the UK, France), as well as key additional countries (the ‘investment hubs’) that will have the obligation to provide double tax relief. The OECD has indicated that the multilateral convention will be available for signature in the first half of 2023. If ratified by sufficient countries, the OECD’s intention is for the Amount A rules to enter into force in 2024.

### Interaction with digital services taxes

A key component of the Inclusive Framework political agreement remains the commitment for the implementation of Pillar One to be coordinated with the removal of unilateral digital services taxes and other relevant similar measures. This will apply for all companies irrespective of their size and is not limited to those in the scope for Amount A.

If Amount A fails to be implemented by the end of 2023, countries will be free to introduce new digital services taxes if they wish. Canada has already introduced legislation for a digital services tax to apply from 1 January 2024 if the Amount A rules are not in force which would be backdated to 1 January 2022. Similarly, agreements made between the US and other countries such as the UK, France, Italy, Spain, Austria, India and Turkey – to allow offset of excess digital services taxes against future Amount A tax in return for the suspension of trade sanctions in respect of existing digital services taxes – applies until 31 December 2023 (and 31 March 2024 for India).

As part of the ongoing work on the definition of digital services taxes and other similar measures that will be repealed, the OECD will produce, by the end of 2022, a draft list of digital services taxes and relevant similar measures using factors such as whether the regimes:

- impose tax based on market-based criteria;
- are ring-fenced to foreign and foreign-owned businesses;
- are outside the income tax system/tax treaties.

### Amount B: Fixed transfer pricing return for marketing and distribution activities

Amount B, which is an amendment to existing transfer pricing rules, is expected to apply much more widely than Amount A. Amount B looks to establish a definition of ‘baseline marketing and distribution activities’ undertaken by group distributors.

The proposal is that Amount B would set a fixed benchmarked return for in-scope activities, potentially varying by industry and/or region. These rules might, and logically would, be implemented as part of the OECD’s Transfer Pricing Guidelines. A consultation document on how Amount B will work is expected to be released by the end of 2022. This will include information on the scope of Amount B, including whether it will apply only to buy/sell distributors that take legal title to goods, or more broadly.

## Pillar Two: global minimum tax rules

The Pillar Two global minimum tax rules are the most developed component of the OECD’s two-pillar approach, with OECD model rules published in December 2021 and subsequent OECD commentary published in March 2022. The rules apply to large multinational groups with annual consolidated group revenue of at least €750 million (broadly those in the scope of country-by-country reporting) and have two key components:

- **An income inclusion rule:** This rule applies on a ‘top-down’ basis. In most cases, including for most UK headed groups, any tax due is calculated and paid by the ultimate parent company to the tax authority in its country. The tax due is the ‘top-up’ amount needed to bring the overall tax on the profits in each country where the group operates up to the minimum effective tax rate of 15%.
- **The undertaxed profits rule:** This rule (sometimes referred to as the undertaxed payments rule) will apply as a secondary (backstop) rule in cases where the effective tax rate in a country is below the minimum rate of 15%, but the income inclusion rule has not been fully applied. The top-up tax is allocated to countries which have adopted the undertaxed profits rule based on a formula.

The OECD model rules use a mixture of accounting and tax concepts and will, in effect, require businesses to keep a third set of books for Pillar Two effective tax rate calculation purposes. The result is inevitably complex, and there remains a number of areas which are not addressed by the OECD commentary and/or where further clarity is needed.

The OECD held a public consultation in March 2022 and received extensive feedback on areas where internationally agreed certainty is needed to allow businesses to efficiently prepare for the introduction of the rules. Key areas include:

- situations where there is a loss in the year but a top-up tax arises under specific rules;
- the data source for deferred taxes (this is expected to be group consolidated financial statements but the language of the model rules suggests individual entity statutory accounts);
- clarification in respect of transition rules, including the meaning of ‘basis’ for assets transferred between group entities and what to do with tax paid on exit when assets are transferred; and
- clarification of when there is a requirement to hypothesise different parent consolidated financial statements when consolidated financial statements are already prepared, e.g. trusts or foundations.

It is hoped that these, and other issues, will be addressed when the OECD publishes an ‘Implementation Framework’ for Pillar Two, expected to be released by the end of 2022. However, it is likely that regular updates will be needed to address areas of uncertainty as they emerge. This approach would be in line with that taken for the OECD Guidance on the Implementation of Country-by-Country Reporting, where regular updates played an important role in ensuring consistent application by different countries.

**Implementation**

The Inclusive Framework political agreement does not require countries to implement the Pillar Two rules but those that do must do so on a consistent basis. Many governments, including the UK, are currently working towards implementation for accounting periods beginning on or after 31 December 2023.

In the UK, HMRC published draft legislation in respect of the implementation of an income inclusion rule in July 2022. The UK’s ‘multinational top-up tax’ will operate as a new tax, separate from the existing corporation tax regime. The draft legislation covers scope, determination of covered taxes and the tax base for the effective tax rate calculation, the calculation of top-up tax amounts, and administration. The UK government has confirmed that a UK qualified domestic minimum top-up tax will also apply alongside the income inclusion rule. There will be a later update on the undertaxed profits rule, which will apply no earlier than accounting periods beginning on or after 31 December 2024.

The UK government approach is to closely follow the OECD model rules. There remain gaps in the UK’s draft legislation, particularly in relation to areas where the OECD is continuing its work, such as on potential safe harbours. The draft legislation includes powers for the amendment of the UK rules to align with the OECD framework, including any future guidance or commentary published by the OECD. Because UK legislative terms and ordering have been used and these differ from the OECD model rules, it is hoped that HMRC will publish a ‘map’ cross-referencing the UK legislation to the OECD model rules to help other tax authorities as well as businesses.

A draft directive for the implementation of Pillar Two in the EU was published immediately after the OECD model rules were released, but it has not yet been possible to obtain the required unanimous agreement from all 27 EU member states, in particular due to current objections from Hungary.

The five largest EU countries – Germany, France, Italy, Spain and the Netherlands – issued a joint statement in September 2022 to say that they will implement the Pillar Two rules directly if unanimity cannot be reached for a directive. This will be achieved through domestic legislation. The Netherlands has subsequently published draft legislation to implement the income inclusion rule, undertaxed profits rule and domestic minimum tax rules.

An increasing number of other countries are also in the process of considering how to introduce the rules into their domestic legislation and/or have issued public consultations, including Australia, Canada, Ireland, Hong Kong, Japan, Malaysia, Singapore, South Korea and Switzerland.

In respect of the US, the Biden Administration legislative proposals to amend the GILTI rules to align more closely with the Pillar Two rules have not been passed. Although the Inflation Reduction Act included a corporate alternative minimum tax of 15%, it does not apply on the same basis and is not a qualified income inclusion rule in Pillar Two terms. US headed groups will be subject to overseas income inclusion rules at an intermediate holding company level where one exists, with the undertaxed profits rule applying to any remaining low-taxed profits, including in respect of activities in the US itself.

## Qualified domestic minimum top-up taxes

The OECD model rules allow for countries to introduce domestic minimum top-up taxes based on the Pillar Two rules. Top-up taxes due in respect of any low-taxed profits of a group's entities within that country would then be paid to the local tax authority, rather than being collected by other countries under either the income inclusion rule or undertaxed profits rule mechanisms. Qualified domestic minimum top-up taxes are perhaps expected to closely follow the OECD model rules but it is not yet clear whether any local country differences will emerge.

The UK government has confirmed that it will implement a UK domestic minimum top-up tax for accounting periods beginning on or after 31 December 2023. It will apply to groups operating in the UK with global revenues over the Pillar Two €750 million revenue threshold, including those operating exclusively in the UK. Other countries are also exploring the introduction of a domestic minimum top-up tax, including Australia, Canada, Hong Kong, Ireland, Malaysia, the Netherlands and Singapore.

## Development of safe harbours

For many businesses, the biggest challenge will be compliance with the complex new rules and collection of the necessary data. The OECD has therefore been working on the development of safe harbours to limit the compliance and administration burden for operations that are likely to be taxable at or above 15% on a jurisdictional basis.

Consideration is being given to the use of country-by-country reporting data, potentially on a temporary basis. The final design of any safe harbours will be reflected in an Implementation Framework, due to be released by the end of 2022.

## Reporting process and administration

Pillar Two will require a step-change for in-scope businesses in terms of global tax compliance – including understanding the rules, collating data, performing and processing the calculations, understanding accounting treatments and adjusting for changes in prior periods, as well as filing additional Pillar Two calculation returns and notifications.

The approach to reporting processes and administration will be set out in the OECD Implementation Framework due to be released by the end of 2022, and will be open to public consultation. A standard template will be developed for an ‘Information Return’ which will include information on: group members; corporate structure; elections and ‘information necessary to compute’ the effective tax rate for each country and top-up tax allocated to each country/group member. Comments from governments indicate that the draft return is lengthy and detailed. It will be important for businesses to provide feedback to assist in developing streamlined approaches wherever possible.

Administration will follow a similar approach to that taken for country-by-country reporting, with the ultimate parent company filing the ‘Information Return’ with its local tax authority, who will then exchange the return with other tax authorities where a qualifying competent authority agreement is in place. The deadline for filing the return will be 15 months after the last day of the accounting period, extended to 18 months for a group’s first return.

Local registration and filing requirements will also be required. The UK rules include an annual short domestic return to confirm entities’ UK top-up tax liabilities, to be filed with HMRC via a digital service outside of the corporation tax return process. The filing deadline will align with the group’s Pillar Two ‘Information Return’. Following consultation, top-up tax is to be paid in a single instalment with the payment date also aligned with the filing date for the ‘Information Return’.

## Subject to tax rule

The political agreement also included a ‘subject to tax’ rule to allow developing countries to deduct tax from payments of intra-group interest, royalties and a defined set of other payments. Countries that apply nominal rates of tax below a minimum 9% rate to such receipts will be required to amend tax treaties on request by developing countries. The taxing right will operate as a top up to the minimum rate of 9%. No further details have yet been published by the OECD.

## What’s next?

There have undoubtedly been significant developments throughout 2022 and the pace is set to continue in December, with updates expected from the OECD in many areas, including the Pillar Two Implementation Framework (including safe harbours), Amount B, and digital services taxes and other similar measures. Countries are continuing to work on the domestic implementation of the OECD model rules for Pillar Two and more countries are expected to release draft legislation over the coming months. 2023 will be a key year for businesses to ensure that they are ready to comply with the rules as they begin to take effect in 2024.

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